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Community Property and the Federal Income Tax

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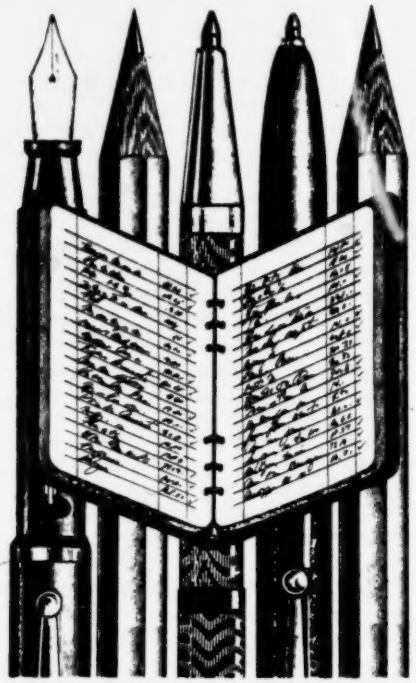
For use in preparing
1980 Returns



You can get the tax forms and publications referred to in this publication by writing to the IRS Forms Distribution Center listed in your Form 1040 or 1040A Instructions. Or, you can call the Tax Information number in the phone book listed under "United States Government, Internal Revenue Service."

Introduction

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This publication is designed for married taxpayers who are domiciled in one of the following community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. You should understand how community property affects the way you figure your tax before completing your federal income tax return. At the end of this publication, you will find a comprehensive example that will explain how income and deductions should be treated when filing your federal tax return.

Domicile

You have only one domicile even though you may have more than one home. Your domicile is a permanent legal home used for an indefinite period of time. The question of your domicile is mainly a matter of your intention. If your domicile or residency is questioned, you must be able to show, with facts, that you intend a given place or state to be your permanent home.

The following are some, but not all, of the factors considered in determining domicile:

Where you were born;

Where you pay state income tax;

Where you vote;

Location of property you own;

Your citizenship; and

Length of residence.

Amount of time spent. The amount of time spent in one place does not always explain the difference between home and domicile. A temporary home may continue for months or years while a domicile may be established the first moment you occupy the property. Your intent is the controlling fact in proving where you actually have your domicile.

Community Property and Community Income

Most married individuals who live permanently in one of the community property states have community income.

You must be legally married to have community income. An absolute decree of divorce ends the community estate, but in Louisiana, it ends by a separation from bed and board.

Death of either spouse ends the community. Income earned and accrued before the date of death is community income if it comes from community property. At death, the community estate is divided.

The laws of the state in which you are domiciled govern whether you have community property or community income.

The differences between community and separate property are important if the husband and wife choose to file separate federal tax returns. Sometimes, it is to the advantage of a husband and wife to file separate returns. When this happens, the income, expenses, deductions, exemptions, and credits of the husband and the wife ***must*** be identified and reported separately.

State law must first be considered before federal tax laws are applied. If a husband and wife choose to file separate returns, the laws of the community property state where they are domiciled govern the classification of their income as separate or community income.

Community property is all property that does not fall within the definition of separate property, and that is acquired by the husband and wife during their marriage and while they are domiciled in a community property state. Each owns half of all the property, according to state law. All community property belongs as much to the wife as it does to the husband.

If property cannot be identified as separate property, it will be considered as community property. Income from community property is community income. It is important for federal tax purposes to classify the property according to the laws of the state in which you are domiciled.

The basis of community property generally is affected by the death of either spouse. For information concerning the basis of property, including community property, see Publication 551, *Basis of Assets*.

Separate property is all the property owned separately by you and your spouse before your marriage. It is also property acquired after marriage by you or your spouse separately as a gift, devise, bequest, or inheritance. Separate property may be acquired during marriage by buying with separate funds or in exchange for separate property.

Generally, once property is classified as separate property, it remains separate property as long as it can be traced. However, in some states separate property may be changed to community property by an agreement between the parties or by operation of law.

Separate property also includes money and property acquired before marriage as well as money earned while domiciled in a noncommunity property state.

In some community property states, a spouse's award for personal injuries, other than the part awarded as compensation for loss of earnings, is that spouse's separate property.

Community income is all the income from community property, and salaries, wages, and other pay for the services of either or both the husband and wife. In some states, income from separate property is also community income. If you and your spouse file separate returns, half of all community income must be reported by you, and the other half by your spouse.

For instance, if you live in Texas, all the earnings from wages of both parties make up

community income. You must classify community income in accordance with state law for federal tax purposes.

There are exceptions to this general rule. In California or in Nevada, a husband and wife may enter into a valid agreement providing that any income earned by either of them for personal services is his or her separate property. Income earned by either of them after the agreement is entered into is treated, for federal tax purposes, as the separate income of the spouse earning the income, not as community income.

Separate income is not necessarily the income from separate property. Generally, under the community property system, income from separate property is income of the spouse who is considered to own the property. However, income from separate property is sometimes recognized to be community income. The method of treating income arising from separate property varies in different states.

Income from property acquired with commingled funds. If you acquire property during your marriage partly with community funds and partly with separate funds, the income from that property must be divided. Income from the part of the property bought with community funds is always community income. Income from the part bought with separate funds is community income or separate income, depending on the laws of the state in which you are domiciled.

Separated Spouses

Separated couples treat their property according to the laws of their state. In all community property states, an absolute decree of divorce or annulment ends the community.

Depending upon the state, a decree of separate maintenance may or may not end a community interest.

Generally, separation agreements divide the community property between spouses. They also provide that this property along with future accumulations of property and the earnings of each spouse will be separate property. These agreements are valid under community property law.

During a period of separation, the property and the income of separated spouses may be either community or separate depending on the community property state law. For a discussion of the different treatment of a separated spouse's income under the different community property states, see Publication 504, *Tax Information for Divorced or Separated Individuals.*

Nonresident Alien Spouse

Certain community property laws do not apply to U.S. citizens or residents, who are married to nonresident aliens and who do not choose to treat the nonresident as a U.S. resident (see the discussion later under *Choosing to be treated as a U.S. resident).* For federal income tax purposes the following types of income are not treated as community income and half is not reported on each spouse's separate return.

Community earned income of a spouse, other than trade or business or partnership income, is treated as the income of the spouse whose personal services produced the income and must be reported on that individual's separate return.

Community trade or business income, other than partnership income, is treated as the husband's income. It is reported on the husband's separate return unless the wife exercises substantially all of the management and control over the trade or business. Then the income is reported on the wife's separate return.

Community partnership income or loss received from a trade or business carried on by the partnership is treated as the income or loss of the partner. It must be reported on the return of that partner. No portion of this share is treated as income of the spouse of the partner.

Community income derived from the separate property of one spouse, which is not earned income, trade or business income, or partnership distributive share income, is treated as the income of that spouse and is reported on that spouse's separate return.

All other community income is treated as provided by the community property laws that apply.

If you choose to treat your nonresident alien spouse as a U.S. resident, these rules will not apply. The community property rules discussed earlier, under *Community Property and Community Income* will then be used.

Choosing to be treated as a U.S. resident. A U.S. citizen or resident married to a nonresident alien may choose to treat the nonresident alien as a U.S. resident. The choice treats the nonresident alien as a U.S. resident for all federal income tax requirements, including subjecting the alien's worldwide income to U.S. income tax.

The choice must be made by both spouses and once made, applies to all later tax years unless ended by the revocation of either spouse, the death of one spouse, legal separation, or the Internal Revenue Service. If the choice is ended for any of these reasons, neither spouse will be eligible to choose to do this for any later tax year.

In order to make the choice, on the last day of the tax year, one spouse must be a U.S. citizen or resident and must be married to a spouse who is a nonresident alien. It is not necessary for the U.S. citizen or resident to have been a citizen or resident for the entire tax year.

By choosing to have your nonresident alien spouse treated as a U.S. resident, you and your spouse will then be eligible to file a joint tax return. You must file a joint return in the year of the choice. You may file joint or separate returns in later years. Community property laws can then be applied and half of all community income is reported on each separate return.

Amended returns. If you filed separate returns for a tax year ending on or after December 31, 1977, you can still make a choice for those tax years by filing amended returns. This may be done by filing Form 1040 or 1040A with the Internal Revenue office where your original return or returns were filed. Be sure to write the word "Amended" clearly on the front of the return.

If you make the choice with an amended return, you must also file amended returns for any later tax years for which you or your spouse have already filed a return.

For more information, see Publication 519, *U.S. Tax Guide for Aliens.*

Preparing a Federal Income Tax Return

Ordinarily, if you are domiciled in a community property state, your combined federal income tax liabilities will not be that different whether you and your spouse file a joint return or file separate returns. But in some cases your combined liability on separate returns will be different from what it would be on a joint return. To figure the best way to file, you must classify your community and separate income.

If you and your spouse file separate returns, an extension of time allowed to you for filing your return does not extend the time for filing the separate return of your spouse.

Classifying income. For classifying taxable income, you must follow state law as it relates to community and separate income. If you have any difficulty in classifying your income according to state law for federal tax purposes, contact your local Internal Revenue office.

Community income exempt from federal tax generally keeps its exempt status for both spouses. For example, under certain circumstances, income earned outside the United States is tax exempt. If you earned income and met the conditions that made it exempt, the income is also exempt to your spouse even though your spouse may not have met the conditions.

Armed Forces pay. State community property laws apply to active military pay and Armed Forces retirement pay that is based on age or length of service. Generally, the character of the pay as separate or community income is figured by the marital status and domicile of the Armed Forces member and spouse during the time the member was in active military service.

The member's active military pay while married and domiciled in a community property

state is community income. This income is considered to be received half by the member and half by the spouse.

Armed Forces retirement pay that is based on age or length of service is regarded as additional pay for past services. Thus, such retirement pay is community income if it is from the member's active military service performed while married and domiciled in a community property state. This is true even though the retirement pay is received in a noncommunity property state.

When the Armed Forces retirement pay is a mixture of community income and separate income, it must be divided between both types of income in the proportion that the length of domicile of the husband and wife in a community property state bears to the member's total period of service.

Example 1. Colonel Thomas Lee retired last year from the U.S. Air Force after 28 years of service. During his entire service career, Colonel Lee was married and was domiciled in Arizona. When he retired, he moved to Phoenix. All of his retirement pay from the Air Force is community income, half of which is considered to be his wife's income. If the Lees move to a noncommunity property state, the retirement pay will still be community income.

Example 2. Major Henry Jones retired last year from the U.S. Army after 20 years of service. Major Jones and his wife were domiciled in a community property state during the last 10 years of that service.

Therefore, since half of the military service was performed while the Joneses were married and domiciled in a community property state, half of the retirement pay is considered to be community income. If Major Jones receives $660 a month retirement pay, half of it ($330) is considered community income, half to him ($165) and half to his wife ($165).

Civil service retirement. For income tax purposes, the state community property laws apply to annuities payable under the Civil Service Retirement Act.

Generally, the character of a civil service annuity as separate or as community income is determined by the marital status and domicile of the employee when the services to which the annuity is attributable were performed. A civil service annuity received by a taxpayer now living in a noncommunity property state may be community income if it is based on services performed by the taxpayer while married and domiciled in a community property state.

When a civil service annuity is a mixture of community income and separate income, it must be divided between community and separate income. The division is made based on the employee's periods of service in community (while married) and noncommunity property states.

Expenses from the production of income such as rents, royalties, dividends, or salaries are classified as community or separate expenses. Expenses are classified as community or separate expenses according to the classification of the income to which they apply.

Example. Tom and Janet Green own an apartment house. In the state in which they are domiciled, the apartment house is community property. If they file separate federal income tax returns, each will report half of the income from the property and each will deduct half of the expenses from the operation of the apartment house.

Itemized deductions on Schedule A (Form 1040), such as charitable contributions, interest, taxes, and medical expenses, generally are considered paid from community funds and deductible half by each spouse, unless it can be shown that they were actually paid from separate funds of the husband or wife. In that case, they are deductible on the return of the spouse who paid them. If one spouse itemizes deductions on a separate return, the other also must itemize.

Losses have the same character as the property from which the loss arose. For example, a loss incurred on separate property, such as stock held separately, is a separate loss. On the other hand, a loss incurred on community property, such as a casualty loss to a car held as community property, is a community loss.

See Publication 544, *Sales and Other Dispositions of Assets,* for information on gains and losses.

Personal exemptions and dependents. When you file separate returns, you must claim your own exemption. You may not claim any part of your spouse's exemption, and vice versa.

The deduction for a dependent may not be divided between husband and wife. You may divide the total of your exemptions for dependents between you, but you may not divide the exemption for any one dependent between you.

Example. Peter White is 65 and supports his wife and three dependent children with community funds. If he files separately, only he may claim his own $1,000 exemption and the additional $1,000 exemption for his age, and only his wife may claim her own $1,000 exemption. Peter may claim any or all three exemptions for his children and his wife may claim the balance or vice versa. They may not divide the total deduction for dependents ($3,000) equally between them. They must divide the deduction into multiples of $1,000 (a full exemption).

Dividend exclusion. If, under the laws of the state in which you are domiciled, dividends are community income, you may each exclude from income the first $100 of qualifying dividends. The exclusion may not be greater than $100 on a separate return or $200 on a joint return.

If the dividends are separate income in your state, only the spouse who owns the stock may claim the exclusion.

For 1981 and 1982, you may claim an exclusion of $200 on a separate return or $400 on a joint return for qualifying dividends and certain interest income.

Tax credit for the elderly. You may claim this credit if you are 65 or older, or if you are under 65 and receive a taxable pension or annuity from a public retirement system. If you are married at the end of 1980, you and your spouse must file a joint return to claim the credit. However, if you and your spouse were not members of the same household at any time during 1980, you may file either a joint return or separate returns and still take the credit.

If you are married, retired under a public retirement system, filing a joint return, and have community income, you should disregard your state's community property rules when figuring the credit for the elderly. The total of all taxable and nontaxable income used in figuring the credit is considered that of the person who earned the income.

If you are married and have lived apart from your spouse for the entire tax year, and you file as married filing a separate return, and either you or your spouse, or both, are domiciled in a community property state, the laws of the state(s) will affect the following items when figuring the tax credit for the elderly:

1) The allocation of income reported on the separate returns;
2) The determination of each spouse's share of social security and railroad retirement benefits; and
3) The allocation of retirement income on separate returns for individuals under age 65 and retired under a public retirement system.

See Publication 524, *Credit for the Elderly,* on how to figure the credit.

Earned income credit. You may receive the earned income credit as a refund, or if you choose, as an advance payment included in your pay. The amount of the credit for 1980 is 10% of earned income, up to a maximum of $500.

However, the amount of the credit is reduced if the amount of adjusted gross income (or earned income, if greater) exceeds $6,000. The credit is completely eliminated when the adjusted gross income reaches $10,000. If the allowable credit exceeds your tax liability for the year, the excess will be treated as a tax overpayment and refunded to you.

To figure your credit, use the 1980 Earned Income Credit Table found in the instructions for Form 1040 and 1040A.

The earned income credit is limited to certain people. To receive the credit:

1) Your home must be the principal home for you and at least one of your dependent children unless you are a head of household. If you file as head of household, your child must live with you in your home, but does not need to be your dependent if the child is unmarried; if the child is married, you must be able to claim the child as your dependent;
2) Your principal home must be in the United States;
3) You must not have excluded from your gross income any amount of income that is earned from foreign countries or U.S. possessions, or claimed a deduction for certain expenses of living abroad;
4) You must have a full 12-month tax year; and
5) You must file a joint return if you are married.

Married taxpayers. If you are married, you and your spouse must file a joint return to claim the earned income credit. However, even though you are married, you may file as an unmarried head of household and claim the credit on your own return if:

1) Your spouse did not live in your home at any time during 1980;
2) You paid more than half the cost to keep up your home in 1980; and
3) Your home for all of 1980 was the main home of your child whom you can take as a dependent.

Your earned income for this credit is computed without regard to community property laws and generally means taxable wages, salaries, tips, other compensation (excluding pensions and annuities), and net earnings from self-employment.

For more information about the credit, see Publication 596, *Earned Income Credit.*

Withholding tax. Federal income tax withheld on community wages is reported in the same manner as your wages. If you and your spouse, domiciled in a community property state, file separate returns and each of you reports half of the community wages, each of you is entitled to half of the credit allowable for the income tax withheld on those wages.

Self-employment tax. For the self-employment tax computation, if any income from a trade or business is community income under the laws of the state in which you are domiciled, all the gross income and the related deductions are treated as gross income and deductions of the husband.

However, if the wife actually exercises substantially all the management and control over the business, then all the gross income and the related deductions are treated as her income and deductions. A wife is not a self-employed person unless she has her own business or is in fact a member of a partnership.

If you are a partner and if your share of any income of the partnership is community income, the entire distributive share is treated as your net earnings from self-employment. No part is treated as net earnings from self-employment by your spouse. If both you and your spouse are partners, then each of you may claim your share in figuring net earnings from self-employment for self-employment tax purposes.

Estimated tax. When applying the tests for filing separate declarations of estimated tax, that is, to see whether an estimated income tax return must be filed, each spouse must take into account:

1) Half the community income and deductions;
2) All of that spouse's separate income and deductions; and
3) The spouse's own exemptions and any exemptions for dependents that the spouse may claim.

Other Helpful Publications

For more detailed answers to your tax questions, use this publication along with the instructions you received with your federal income tax return, with Publication 17, *Your Federal Income Tax,* and with Publication 334, *Tax Guide for Small Business.* If your tax problem concerns farming, get Publication 225, *Farmer's Tax Guide.*

Comprehensive Example

Walter and Mary Adams are married and domiciled in a community property state. Their two minor children and Mary's mother live with them and qualify as their dependents. Amounts paid for their support were paid out of community funds.

Walter received a salary of $20,500 in 1980. Income tax withheld from his salary was $3,369.60. Walter received $49 in taxable interest and had stock in White Corporation from which he received $145 in qualifying dividends during the year. His interest and dividend income is his separate income.

Mary inherited stock in the Brown Corporation from her father. She received $130 in qualifying dividends from that stock. This is her separate income. In addition, she received $5,200 as a part-time dental technician. Income tax withheld from her salary was $291.20.

Walter received $164 in excess reimbursement from his employer for ordinary and necessary business expenses incurred while traveling away from home. Since Walter accounts to his employer for all his business expenses he is required to include only his excess reimbursement in his income tax return.

The Adams' personal expenses during the year included contributions of $720; interest of $95 on a bank loan; credit card interest charges of $30; state income taxes of $644.80; property taxes of $742 on their home; and state and local sales taxes of $373. These were paid from community funds.

Walter paid dues of $30 to the local Chamber of Commerce and $65 to the Institute of Accountants. Both were necessary in his job. Mary bought 4 nurse's uniforms for her part-time job as a dental technician. Each cost $20, and she spent $26 having them laundered during the year. Mary also had a $325 casualty loss on her own car as a result of a collision. Her car was bought from her separate funds.

Medical insurance cost $240 and was paid from community funds. Before buying the insurance, Walter had a serious operation and paid $2,235 for doctors and hospital bills and $325 for medicine and drugs. He paid these expenses out of $3,000 he inherited from his father last year.

To see if it is to the Adams' advantage to file a joint return or separate returns, a worksheet is prepared computing their federal income tax. Walter and Mary must claim their own exemption on separate returns. A reproduction of their worksheet appears later.

After completing the worksheet, it was found that when filing separate returns it is to the Adams' combined advantage for Mary to claim the exemption for her mother and one of the children; while Walter claims the exemption for their other child. If the Adamses file separate returns they could save $101 in income tax. Therefore, they should file separately.

If the Adamses were domiciled in Idaho, Louisiana, or Texas, the result would be slightly different, because in those states, income from separate property generally is treated as community income. If they lived in one of those states, half the interest on their savings account and half the dividends from stock owned by each of them would be divided equally on their separate returns. Both Walter and Mary would report dividends of $37.50, instead of $45 for Walter and $30 for Mary.

WORK SHEET

Walter and Mary Adams

	Joint Return		Separate Returns			
			Walter's		Mary's	
Income (Walter's):						
Salary	$20,500.00		$10,250.00		$10,250.00	
Travel, excess reimbursement	164.00		82.00		82.00	
Interest	49.00		49.00			
Dividends ($145 less $100 exclusion)	45.00		45.00			
Total		$20,758.00		$10,426.00		$10,332.00
Income (Mary's):						
Salary	$ 5,200.00		$ 2,600.00		$ 2,600.00	
Dividends ($130 less $100 exclusion)	30.00				30.00	
Total		5,230.00		2,600.00		2,630.00
Adjusted gross income (AGI)		$25,988.00		$13,026.00		$12,962.00
Deductions (Community):						
Contributions	$ 720.00		$ 360.00		$ 360.00	
Interest	125.00		62.50		62.50	
Taxes	1,759.80		879.90		879.90	
Dues	95.00		47.50		47.50	
Uniforms and laundry	106.00		53.00		53.00	
Total		$ 2,805.80		$ 1,402.90		$ 1,402.90
Deductions:						
One-half of medical insurance[1]		120.00		60.00		60.00
Medical expenses (Walter's):[2]						
Medicine and drugs	$ 325.00		$ 325.00			
1% of AGI	259.88		130.26			
Balance	$ 65.12		$ 194.74			
Other medical expenses	2,235.00		2,235.00			
Balance of medical insurance	120.00		60.00		60.00	
Total	$ 2,420.12		$ 2,489.74		$ 60.00	
3% of AGI	779.64		390.78		388.86	
Balance		1,640.48		2,098.96		-0-
Deductions (Mary's):						
Collision loss ($325 less $100 limitation)		225.00				225.00
Total deductions		$ 4,791.28		$ 3,561.86		$ 1,687.90
Less zero bracket amount		3,400.00		1,700.00		1,700.00
Excess itemized deductions		$ 1,391.28		$ 1,861.86		
Mary's unused zero bracket amount[3]						$ 12.10
Tax table income[4]		$24,596.72		$11,164.14		$12,974.10
Tax liability[5]		$ 3,123.00		$ 1,415.00		$ 1,607.00
Less: Federal income tax withheld	$ 3,660.80		$ 1,830.40		$ 1,830.40	
Estimated tax paid	-0-		-0-		-0-	
Total		3,660.80		1,830.40		1,830.40
Overpayment		$ 537.80		$ 415.40		$ 223.40

[1]One-half of the medical insurance (not to exceed $150) is deductible without regard to the 3% AGI limitation.

[2]Even though Walter may have used savings or an inheritance to pay for these expenses, they are nevertheless deductible on his return.

[3]The unused zero bracket amount is the excess of the zero bracket amount ($1,700 for married filing separately) over itemized deductions ($1,687.90).

[4]Tax table income is found by subtracting the excess itemized deductions from AGI on the joint return and on Walter's separate return. On Mary's separate return, tax table income is found by adding the unused zero bracket amount to AGI.

[5]The tax on the joint return is from the tax table for married filing jointly with 5 exemptions. On Walter's separate return, the tax is arrived at from the tax table for married filing separately with 2 exemptions, while Mary's separate return is taxed for married filing separately with 3 exemptions. By giving Mary the additional exemption, income is made more equal and thus results in a lower combined tax liability.

SUMMARY

Tax on joint return		$3,123.00
Tax on Walter's separate return	$1,415.00	
Tax on Mary's separate return	$1,607.00	
Total tax filing separate returns		$3,022.00
Tax savings by filing separate returns		$ 101.00